HAMILTON POINT
Investment Advisors, LLC
CHAPEL HILL, NC • CLINTON, NY

ANDREW C. BURNS
President/Chief Investment Officer

RICHARD S. WOODS
Chief Operating Officer

JULY 2009

Following by Example?

Humans make comparisons when seeking perspective. Perhaps it is a Darwinian trait – where those most aware of their relative position were more likely to survive. This Newsletter argues that when it comes to investing money, so-called "relative benchmarking" can lead to poor decisions. In fact, we expect that historic overreliance on benchmarks for both measuring success and as an actual investment philosophy will result in poor future performance for assets managed by closely mirroring an index. At Hamilton Point, we avoid investment purchases that lack merit beyond their heavy weighting in an index. We also alert investors that we currently find an exceptionally large portion of the broad market to be simply "un-investable" at this time.

To be sure, benchmarking – which textbooks tell us is the act of comparing a specific process to an industry standard – can be a helpful endeavor. For example, a study of cardiac clinics might point to differences in outcomes that result in life-saving recommendations. It is how a study controls certain variables though, that must be understood before drawing any serious conclusions. For example, would patients want cardiac-care standards automatically set by the average performance of only the 100 largest clinics? What if smaller clinics were better?

DANGER IN DEFINING RISK VIA A BENCHMARK

So-called financial experts have convinced many that benchmarks are *the* essential part of investment performance measurement. Perhaps even more insidiously, they cleverly measure investment "risk" as the degree to which a portfolio varies from the benchmark. Although sounding logical, the underlying assumptions are dangerous and have served to destroy tremendous wealth in our country. Blindly following an index or judging a portfolio's risk based upon how "over or under weighted" it is relative to a benchmark is, in our view, no different than when a child justifies their behavior because "everybody else is doing it."

The very construction of indexes is rather arbitrary in terms of dictating an investment philosophy. The hoopla and trading that takes place on the margin when stocks are added or dropped into these faux buckets is amazing. For example, after Russell reconstructed their key indexes in June 2008, the Oil, Energy and Materials sectors' weighting in the Russell 1000 index (a large-cap index) increased 4.6%.[1] That meant that managers tracking the Russell 1000 index had to add stocks in these richly-valued sectors just before an enormous selloff in these holdings weeks later. These purchases were made almost entirely on the basis of benchmark weightings as opposed to any other investment thesis.

PRESERVING CAPITAL OR BENCHMARKS?

Recent history has shown that following the benchmark can lead to some careless investment decisions that *increase* risk, using a common-sense based assessment. In the height of the internet stock bubble, the technology sector grew to comprise more than 30% of the S&P 500 Index, the most institutionally recognized benchmark for measuring stock investment success. **Cisco** was then the largest company by market value, and by definition, every investor in index funds had to own it in large proportions – as did large so-called closet index funds – even though its valuation was indefensible. For

[1] Source: Russell Investments

CONTINUED ON REVERSE >

perspective, **Exxon** is now worth just over $300 billion and earned $45 billion last year. At its peak in 2000, Cisco was worth close to $600 billion but earned just $2.7 billion then—clearly a wacky valuation[2], but not one to scare away most money managers at the time because the "risk," as they were taught it, was in *not* owning it and other over-valued stocks that dominated the index. ("But Mommy, all the other kids stay up late.") If you think lessons were learned, then fast forward to a timelier example concerning the financial sector in 2007. Like the tech sector in 2000, financials began to comprise a significant portion of the index—causing benchmark-based investors to fret about the risks of being "underweighted" financial holdings, regardless of excessive leverage and looming real estate problems.

Nonetheless, the marketing departments of the mega-fund management firms have long sought comfort in the feeling that they could protect their business plans if returns simply *approximated* index returns. This logic began the process wherein the investment community tried to preserve theoretical benchmarks instead of client capital. Moreover, as assets under management grow for large institutions, it becomes not only the "safe" approach, but a necessary one. Funds with billions under management end up spreading their money across dozens (often hundreds in the case of some funds) of individual stocks. Are these the fund managers' best picks they believe will produce superior returns? We believe the answer is clearly "no" in most cases.

RESEARCH REVEALS FLAWS IN BENCHMARKING

Our long-held suspicions about these trends in money management are supported by Martin Cremers' and Antti Petajisto's research, published by the Yale University School of Management.[3] After extensive analysis of the performance and holdings of domestic equity mutual funds from 1980 to 2003, Cremers and Petajisto reached the following conclusions:

1. Small funds with less than $1 billion of assets are more "active" (high deviation from benchmark), while larger funds are more typically "closet indexers" (i.e. non-index funds with relatively low deviation from benchmark)
2. This shift to closet indexing became more prevalent starting in the 1990s
3. The most actively managed funds meaningfully outperformed the closet indexers (and the index) both before and after expenses

VALUE IN FLEXIBILITY, FREEDOM FROM BENCHMARKS

In contrast to the largest firms, one of which recently rolled out an advertising campaign touting their $1.3 trillion in client assets, we believe that Hamilton Point's boutique size is a decided strength that permits a highly selective approach to stock selection. Unfortunately for the investing public, many capable money managers simply do not have our flexibility and inevitably destroy capital by following others.

Though we can never guarantee performance, we are able to deliver a diversified portfolio that reflects our beliefs on the best available investment opportunities, given client goals and objectives. This is particularly important in volatile markets, such as now, where large segments of the investment universe are unappealing, due to excessive debt, lack of regulatory clarity, valuation or any of the other investment criteria we use to eliminate stocks from consideration. To be specific, of the 44 largest companies, which comprise roughly half of the market value of the S&P 500, we own only 11 of them at this time. While many money managers spend the third quarter of 2009 looking back at the annual mid-year reconstitution of indexes and rebalance accordingly, we intend to remain selective and forward-looking in our research as we position Hamilton Point-managed portfolios for the future.

Andrew C. Burns
ABurns@HamiltonPoint.com
Richard S. Woods
RWoods@HamiltonPoint.com

[2] Interestingly, Cisco currently has an enterprise value of $80 billion and earned $8 billion last year.
[3] K. J. Martin Cremers, Antti Petajisto, *How Active is Your Fund Manager? A New Measure That Predicts Performance*, Yale School of Management, March 31, 2009.